



VAT alert Belgium

Preventing the artificial avoidance of PE status



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On 31 October 2014, the OECD, as part of its work on the Action Plan to address Base Erosion and Profit Shifting (BEPS), released a Discussion Draft on Action 7 in relation to preventing the artificial avoidance of permanent establishment (PE) status.

The work on permanent establishments is a key facet of the BEPS project, and one that has potentially far-reaching consequences for both businesses and governments.

The proposals do not yet represent a consensus view from the G20/OECD governments involved, but are to be viewed as proposals for public analysis and comment. However, although still in draft, businesses and especially centralised businesses, are advised to consider their structures and supply chains now, and work out how the proposed changes may affect their tax and compliance positions. Businesses may consider alternative models if need be, requiring an overall review of the business and operations. An integrated approach will be key in the overall plan and should be factored in from the start.

Businesses are also advised to participate in the OECD's consultation process to help the OECD understand the consequences of the proposals in scenarios not envisaged by the Focus Group working on this Action.

Proposals for amendments to article 5

Artificial avoidance of PE status through *commissionnaire* arrangements and similar strategies: The OECD proposes changes to the current rules on dependent and independent agents. The changes are intended to limit the currently favourable treatment of commissionnaire and similar arrangements (as well as potentially limited risk distributors through changes to specific exemptions, below). Activities performed by an intermediary in a sales country that are intended to result in the regular conclusion of contracts by a foreign entity might in the future create an agency PE (taxable presence) of the foreign entity. The exception for independent agents remains, but the Discussion Draft proposes tightening the rule to make it clear this will not apply to an agent acting (almost) only for affiliated companies. The Discussion Draft puts forward four alternative (but similar) proposals to amend the agency PE provisions (paragraph 5 of article 5 of the model treaty). The alternatives are:

- A. Proposals to add a reference to contracts for the provision of property or services by the foreign entity where the intermediary “engages with specific persons in a way that results in the conclusions of contracts.”
- B. Proposals to add a reference to contracts for the provision of property or “services by the foreign entity where the intermediary “concludes contracts, or negotiates the material elements of contracts.”
- C. Proposals to focus on contracts which, by virtue of the legal relationship between the agent and the foreign enterprise “are on the account and risk of the enterprise’ where the intermediary ‘engages with specific persons in a way that results in the conclusion of contracts.”
- D. Proposals to focus on contracts which, by virtue of the legal relationship between the agent and the foreign enterprise, “are on the account and risk of the enterprise’ where the intermediary ‘concludes contracts, or negotiates the material elements of contracts.”

It is difficult to see what in practice the exact bearing is of the current proposals and, in particular, whether they can be determined consistently. In addition, the OECD proposes to strengthen the requirements (paragraph 6 of article 5 of the model treaty) for an agent to be considered “independent” such that it does not create a PE of a foreign entity. The exemption would only apply where the agent is acting on behalf of “various persons” and specifically clarifies that acting “exclusively or almost exclusively on behalf of one enterprise or associated enterprises” will not be sufficient to be considered an independent agent.

Artificial avoidance of PE status through the specific activity exemptions: The OECD proposes changes to the list of exceptions for specific activities (such as maintenance of stocks of goods for storage, display, delivery or processing, and purchasing) under which a fixed place of business is treated as not creating a PE (paragraph 4 of article 5). This is a proposal to modernise the exemptions for activities, such as warehousing, that would have been considered preparatory or auxiliary when the model tax treaty provisions were originally negotiated. Modern ways of doing business and, in particular, internet sales have made warehousing in the form of sophisticated logistics centers a key part of some businesses’ value chains; it is clear that many governments think the current exemption is far too wide. The Discussion Draft discusses possible alternative amendments, going from a “catch all” approach that will require analysis of businesses’ value chains to a series of more targeted amendments that will remove altogether the application of exemptions for some activities:

- E. A catch-all requirement that for the exemption to apply, each specific activity (or the combination of activities) must be of a “preparatory or auxiliary character.”
- F. An alternative proposal if E is not adopted would be to remove “delivery” from the specific activity exemptions.
- G. A further proposal if E is not adopted would be to remove “purchasing goods or merchandising” from being a specific activity for exemption.
- H. An alternative to proposal G if proposal E is not adopted would be to remove “purchasing goods or merchandising” and “collecting information” from being specific activities for exemption.

In addition, the OECD is concerned with situations where activities are “fragmented” between related parties to meet the requirements for activities to be preparatory or auxiliary. Two alternative proposals are put forward here:

- I. Under this proposal the specific activity exemptions will not apply where “the same enterprise or an associated enterprise” carries on activities, one of the enterprises has a PE (under the provisions of the rest of article 5) and the business activities constitute “complementary functions that are part of a cohesive business operation.”
- J. Under this proposal the specific activity exemptions will not apply as with proposal I and also where the “overall activity resulting from the combination of the activities... is not of a preparatory or auxiliary character” where the activities constitute “complementary functions that are part of a cohesive business operation.” Under this option, there is no need for one or other enterprise to have a PE under the rest of the provisions of article 5.

Splitting up of construction contracts: The OECD is considering proposals to deal with the splitting up of contracts between related parties in relation to the specific 12-month time period for creating permanent establishments for building sites, construction or installation projects (paragraph 3 of article 5) (and also non-OECD model services PE articles for countries that have adopted them). The proposals put forward are as follows:

- K. For purposes of determining the 12-month period, activities carried on by associated enterprises will be added to the period of time of an enterprise’s activities on site.

- L. As an alternative to the specific rule proposed in K, the principal purposes test proposed in relation to preventing treaty abuse under Action 6 of the BEPS Action Plan could be used to address splitting up of contracts. An example would be added to the Commentary on article 5 of the model treaty to illustrate this.

Insurance: The Discussion Draft considers specifically a concern that has been raised that insurance companies may do large-scale business in a country without having a PE. The OECD is considering two alternative approaches here and asks for input on whether re-insurance raises specific concerns related to the avoidance of PE status. The approaches are:

- M. A specific PE threshold, similar to that found in the UN model, for insurance companies, “if it collects premiums in the territory ... or insures risks situated therein.” Re-insurance is excluded from this.
- N. Under this proposal, there would be no specific treaty provision for insurance companies, and any issues would be dealt with through the proposed changes to PEs in respect of sales in options A-D, which apply equally to insurance as to other industries.

Profit attribution to PEs and interaction with action points on transfer pricing

This section recognises the need to coordinate the work on thresholds for PEs with the BEPS work on transfer pricing (particularly on interest deductions and other financial payments, intangibles and risks and capital) and the allocation of profits to PEs under existing principles. The Discussion Draft comments that the preliminary work by the OECD to date has not identified substantial changes that would need to be made in relation to the attribution of profits to a PE (although some additions and/or clarifications would be useful). The OECD acknowledges, however, that work on other areas, in particular risks and capital, might involve a reconsideration of some aspects of the existing rules.

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